

Institution and settlement of injunctive actions.

Institution and settlement of administrative proceedings of an enforcement nature.

Formal orders of investigation.

At times, changes in Commission priorities require alterations in the scheduling of meeting items. For further information and to ascertain what, if any, matters have been added, deleted or postponed, please contact: The Office of the Secretary at (202) 942-7070.

Dated: September 22, 1997.

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39086; File No. SR-PCX-97-18]

Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Numbers 1, 2 and 3 to Proposed Rule Change Relating to the PCX Application of the OptiMark System

September 17, 1997.

I. Introduction

On June 11, 1997, the Pacific Exchange, Inc. ("PCX" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to establish rules for a new exchange facility called the PCX Application of the OptiMark System ("PCX Application" or "Application"). Notice of the proposed rule change appeared in the **Federal Register** on June 19, 1997.³ Fourteen comment letters were received in response to the proposal.⁴ On August

1, 1997, PCX submitted an amendment ("Amendment No. 1") to the proposal, as well as two letters containing supplemental information.⁵ On August 29, 1997, PCX submitted a second amendment ("Amendment No. 2") to the proposal.⁶ On September 16, 1997, PCX submitted a third amendment ("Amendment No. 3") to the proposal.⁷ This order approves PCX's proposal, as amended.

II. Description of the Proposal

A. Summary of the PCX Application and Purpose

The Exchange proposes to establish rules for a new exchange facility called the PCX Application of the OptiMark System. The PCX Application of the

Denning, General Atlantic Partners, dated July 2, 1997; Theodore E. James, Jr., Van Kasper & Company, dated July 3, 1997; Junius W. Peake, University of Northern Colorado, dated July 7, 1997; Theodore R. Aronson, Aronson & Partners, dated July 7, 1997; Praveen K. Gottipalli, Symphony Asset Management, dated July 8, 1997; Robert A. Hill, Melvin Specialists, Inc., dated July 9, 1997; Tim McCarthy, Charles Schwab, dated July 10, 1997; Todd Greenberg, ProActive Capital Management, dated July 10, 1997; Matt Fong, Treasurer, State of California, dated July 10, 1997; Harold S. Bradley, American Century Investment Management, Inc., dated July 15, 1997; James E. Buck, New York Stock Exchange, Inc. ("NYSE"), dated July 15, 1997; Tom C. Tinsley, Baan Company, N.V., dated July 17, 1997; Bill Porter and Christos M. Cotsakos, E*Trade Group, Inc., dated July 21, 1997.

⁵ Letter from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, dated Aug. 1, 1997. In Amendment No. 1, PCX made a technical amendment to its short sale rule, and provided clarification regarding the application of Rule 10a-1 under the Act to short sales in the PCX Application. Also in Amendment No. 1, PCX responded to comments made by the NYSE.

⁶ Letter from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, dated Aug. 29, 1997. In addition to Amendment No. 2, the PCX also submitted two letters containing supplemental information. See Letter from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, dated Aug. 29, 1997 (regarding issues related to the Intermarket Trading System) ("PCX ITS Letter"), and Letter from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, dated Aug. 29, 1997 (regarding interaction of the PCX Application with the PCX floor) ("PCX Floor Letter").

⁷ Memorandum from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, dated Sept. 16, 1997. In Amendment No. 3, PCX clarified the manner in which Primary Market Protection ("PMP") orders will be executed once the Application is implemented. The letter also includes several trading scenarios that illustrate the operation of the Application vis-a-vis PCX specialists.

"OptiMark System"⁸ is a computerized, screen-based trading service intended for use by Exchange members and their customers. The OptiMark System would provide automatic order formulation, matching, and execution capabilities in the equity securities listed or traded on the Exchange ("PCX Securities"). The OptiMark System would be used in addition to PCX's traditional floor facilities, to buy and sell PCX Securities.⁹

Specifically, the Application would allow PCX members and their customers to submit anonymously from their computer terminals ranges of the trading interest to the OptiMark Systems. At specified times during the trading day, the OptiMark System would conduct certain calculations against such expressions of interest to identify specific orders capable of execution. All orders formulated by the OptiMark System would be automatically executed on the Exchange, except to the extent that they are executed on other market centers through the Intermarket Trading System ("ITS"). The Exchange has stated that the proposed facility would meet institutional investors' growing demand for a new trading medium. The Exchange also expects retail investors to benefit from the operation of the PCX Application.

B. Description of the Proposed PCX Application Operation

The PCX Application was developed jointly by the Exchange and OTI. Exchange members and their customers will trade on the OptiMark System in the manner described below:

Proposed Method of Operation

Two distinct operations would be involved in running the PCX Application: (i) The central information processing system and related administrative and communications

⁸ The OptiMark System was developed by OptiMark Technologies, Inc. ("OTI"), a computer technology firm located in Durango, Colorado, based on certain patent-pending technology referred to as "OptiMark™." OTI has represented that the PCX Application is expected to be one of several different trading services based on that technology that will be made available from the OptiMark System for other exchanges and markets in the future. OTI expects its wholly-owned subsidiary, OptiMark Services, Inc. ("OSI"), which currently plans to apply for registration as a broker-dealer, to be responsible for operating portions of the PCX Application for the Exchange and delivering the trading service to the Exchange's members and their customers. OTI is licensing the OptiMark System to OSI for purposes of the PCX Application.

⁹ This rule filing addresses trading in PCX Securities only. PCX represents that if and when it proposes to extend the Application to options or other types of securities listed or traded on the Exchange, a rule change proposal will first be filed with the Commission.

¹ The Exchange originally submitted this filing to the SEC on May 20, 1997. On June 3, 1997, the Exchange submitted Amendment No. 1 to the filing. The Exchange resubmitted the entire filing on June 11, 1997. The resubmitted filing incorporates the substance of the June 3, 1997, Amendment No. 1. All subsequent references in this order to "Amendment No. 1" refer to the amendment, dated Aug. 1, 1997, submitted as an amendment to the June 11, 1997 filing. See note 5, *infra*.

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 38740 (June 13, 1997), 62 FR 33448 (June 19, 1997).

⁴ Comment letters to the Commission were received from Thomas D. Burke, Newbridge Securities, Inc., dated July 1, 1997; Steven A.

terminal network of the OptiMark System, which includes computers that collect and process data, log activities, and switch messages from and to other systems and carriers, as well as the communication network linking such computers with customer terminals; and (ii) the computer hardware and software needed (collectively, the "PCX Interfaces") for the OptiMark System to communicate with PCX's computerized order system (including any terminals in use by PCX specialists or floor brokers). The Exchange would continue to operate its electronic linkages with the ITS, Consolidated Quote System ("CQS"), and the Consolidated Tape System ("CTS"), as they currently exist.

The Exchange would have direct ownership of and control over the PCX Interfaces. The OptiMark System would provide such electronic communications and information services needed for the PCX Application to operate. From time to time, various services provided by the OptiMark System would be modified to allow for system improvement and enhancement. The Exchange would assure that, at all relevant times, the material terms and conditions of the PCX Application would comply fully with the applicable rules of the Exchange.

Access to the PCX Application

The PCX Application would be available to all members of PCX and, through them, to non-members such as institutional investors and other non-member broker-dealers. Each interested member and non-member customer would be eligible to enter into a subscription agreement ("User Agreement") with OTI and also to execute an agreement with OSI authorizing the delivery of the trading service made available from the OptiMark System.

The OptiMark System subscribers ("Users") would log in from their own computer terminals and communicate with the OptiMark System over customary commercial information services and networks of their choice. Those Users that serve as specialists and floor brokers on the Exchange could also communicate with the OptiMark System from certain computer terminals located on the floor of the Exchange. Security codes and protocols would be required to log in to the OptiMark System. Once logged in, Users with authorized access to the PCX Application would be able to submit certain expressions of their trading interest in a PCX Security to the OptiMark System. Users would be responsible for all of such expressions and any other messages submitted to the

OptiMark System under their passwords and security codes.

Under PCX's proposal, each member of the Exchange would be granted access to the PCX Application directly as a User. Any orders formulated and matched by the OptiMark System based on the expressions of trading interest received from a member User would be automatically routed, executed and reported in that User's name. Each such member User would be responsible for all transactions resulting from the PCX Application for its own or customer accounts in the same way that it is currently responsible for transactions on the floor.

Non-member Users would be required to designate in advance member firms ("Designated Brokers") that would authorize their access to the PCX Application. Under a non-member's agreement with a Designated Broker ("Give-Up Agreement"), the Designated Broker would accept responsibility for that non-member User's transactions and provide a written statement to the Exchange to that effect. Under the Designated Broker's agreement with OSI ("Transmission Consent Agreement"), the Designated Broker would authorize any and all orders formulated and matched by the OptiMark System based on the expressions of trading interest received from the non-member User to be automatically routed, executed and reported in the Designated Broker's name. Both agreements must be in force before any non-member User may be given access to the PCX Application. At a minimum, the provisions in these agreements would include any credit limits that may be imposed by a Designated Broker (or its clearing broker if applicable) on a non-member User;¹⁰ the Designated Broker's undertaking that it is responsible for the non-member User's transactions; and such other terms and conditions that may be agreed to from time to time.

Entry of Profiles

Under PCX's proposal, a User would submit an expression of its trading interest in the form of a "satisfaction profile" ("Profile"), which would indicate the User's degree of satisfaction or willingness (expressed as a number between zero and one) to trade at each coordinate of a price/size grid. A User may depict a varying degree of its

¹⁰ A non-member User's credit limits, as they may be established from time to time by a Designated Broker (or its clearing broker if applicable), will be programmed into the OptiMark System. In addition, the Designated Broker will be notified as its potential exposure to its customers, individually or in the aggregate, approaches the established credit limits.

trading preferences, covering a range of prices and sizes, in a Profile.

The price/size grid over which Profiles are entered would be unitized into individual coordinates. The price axis would be divided into the minimum trading increments in the relevant security being traded.¹¹ The size axis would be divided into 1,000 share increments. A User could create a three-dimensional Profile over each coordinate in the desired region of the price/size grid by indicating a degree of willingness (a "satisfaction value") to trade at that coordinate. Such willingness to trade or satisfaction value could range from the most satisfactory (i.e., "1" satisfaction value) to a cut-off point at which a transaction at that price and size becomes undesirable (i.e., "0" satisfaction value).

The delineation of the size axis into 1,000 share increments for purposes of defining a Profile is distinguishable from the minimum units of trading in the PCX Application, which are in round lots. An example provided in the Exchange's proposal would be a User seeking to submit a buy Profile for 4,100 shares that shows a 100% willingness to trade at the price of 20, decreasing to no willingness as the price reaches 22. Because of the 1,000 share increments on the size axis, the User's interest in excess of 4,000 shares (i.e., the 100 shares) would be reflected in the next available higher coordinate size—5,000. To draw this Profile on the grid, the User would assign the satisfaction value of 1 to all the coordinates with the associated size of 5,000 shares or less and price of 20 or below. As the associated price increases from 20 to 22, the satisfaction value of the relevant coordinates would decrease steadily down to 0. According to the Exchange, the grid size of 5,000 shares does not mean that the User actually would receive a 5,000 share trade in excess of the desired amount, because the User could enter an instruction as part of the Profile to limit the transaction size to 4,100 shares.

According to the proposal, each User may specify, with respect to each Profile submitted, an associated maximum quantity of shares in any round lot multiples starting at 1,000 shares; provided, however, those Profiles submitted by PCX specialists and certain system-generated CQS Profiles (as discussed below) would each have the associated round lot size reflected in the relevant limit order book or

¹¹ PCX recently amended its rules in order to trade equity securities in minimum increments of $\frac{1}{16}$ of a dollar. See Securities Exchange Act Release No. 38780 (June 26, 1997), 62 FR 36087 (July 3, 1997).

quotation, which may be less than 1,000 shares. In addition, Users may, at their option, set boundary conditions on a Profile to restrict the total number of shares that may be purchased or sold within any particular price or size range. Similarly, Users may, at their option, place restrictions on any potential purchase or sale of shares through the ITS.

Users would submit Profiles through their own computers or computers on the floor of the Exchange. All Profiles received by the Application from a User would be treated confidentially and would be viewed only by that User. Unlike orders entered on the Exchange's traditional floor facilities, Profiles would not be widely disseminated to elicit any trading interest when they are received. Instead, they would be logged and maintained by the OptiMark System until they are centrally processed. As discussed further below, Profiles would not be executable outside of the specified times. As trading interest contingent upon such periodic processing, Profiles received by and kept within the OptiMark System would have no standing against orders on the floor and no bearing on the Exchange's traditional auction-pricing mechanism.

The Exchange has represented that, in accordance with its general audit trail requirements, all Profiles submitted by Users would be appropriately marked as proprietary or agency. In addition, each would be time-stamped with a unique serial number when received by the OptiMark System.¹² Users would be able to revise or cancel their own Profiles at any time prior to commencement of the next scheduled central processing. According to the Exchange, because it would be important for Users to be able to adjust their outstanding Profiles in a timely manner in response to sudden market developments, adjustments would be processed in the next central processing scheduled to take place more than one second after receipt. Submitting a revised Profile would result in a new time stamp, unless the only change made is a reduction in the maximum quantity of shares previously specified.

According to the Exchange, all Users would be held responsible for the terms and conditions contained in their Profiles. Each User would assume any and all responsibility for canceling or revising its Profile. Users would be able

to specify in advance whether to cancel their outstanding Profiles or to keep such Profiles active in the event of an unexpected interruption experienced in their own telecommunications linkage to the OptiMark System. If a User decided to keep its Profile active, it would be accountable for any and all transactions resulting from the PCX Application based on such Profile.

Under PCX's proposal, the first match in a Cycle (as defined below), if it involves a short sale, will only be effected if it meets the requirements of Rule 10a-1 under the Act,¹³ i.e., if it is at a price above the last sale price reported on a consolidated transaction reporting system immediately prior to commencement of the Cycle, or at the last reported price if such price is above the next preceding different price. After the first transaction in the Cycle, short sale orders will only be executed at a price: (i) Above the price of the immediately preceding match within the Cycle, or (ii) equal to the immediately preceding price if such price is above the next preceding different price. PCX has requested an exemption from Rule 10a-1, the Commission's short sale rule, to permit matches within a Cycle (those subsequent to the initial match) to utilize the immediately prior match as a reference trade for determining short sale rule compliance.¹⁴

The OptiMark System would perform the necessary credit verification procedures on each Profile submitted by a non-member User. Such procedures would ensure that the maximum absolute dollar value of each Profile received by the OptiMark System, when added to the non-member Users' current credit usage, is consistent with the applicable credit limits. All Profiles not meeting the credit validation requirement would be deactivated.

Interaction With Existing Market Interest

According to the Exchange, the PCX Application is designed to provide Users with certain automated access to and interaction with quotations emanating from other participating market centers of the ITS. At the specified times during the trading day when central processing by the OptiMark System is scheduled to occur, the prevailing bid and offer quotations in CQS from each such market that may be reached by ITS, including the

Intermarket Trading System/Computer Assisted Execution System interface ("ITS/CAES"), would be transformed into a pair of buy and sell Profiles ("CQS Profiles"). Each CQS Profile would have, for the relevant limit price and size, a satisfaction of 1 for all the corresponding coordinates in the price/size grid. The Exchange has represented that creation of these CQS Profiles and their interaction with the Profiles submitted by Users would ensure that the PCX Application is consistent with the intermarket price protection requirement under the ITS Plan.

According to the Exchange's proposal, the PCX Application is also designed to serve as an additional trading service for the Exchange specialists and floor brokers to use in handling existing market interest on the floor. In their capacity as Users, the specialists and floor brokers would be able to submit Profiles based on their customer limit orders. The PCX specialists would be provided with a uniquely designed electronic interface at their posts that would provide simple retrieval instructions to facilitate designation of customer orders on their limit order books for inclusion as Profiles in the OptiMark System. Such an interface also would permit PCX specialists to revise and/or cancel the relevant Profile if any of the limit orders reflected in the Profile subsequently became executable against some other market interest. The Profiles created from a PCX specialist's book would be treated the same as any other Profiles submitted by Users of the OptiMark System.¹⁵ Similarly, floor brokers would have the ability to use existing terminals or designated OptiMark System terminals on the trading floor to submit Profiles if they wish to use the PCX Application to fill existing customer interest.

Central Processing

All Profiles received by the OptiMark System (including CQS Profiles) for each relevant security would be centrally processed by computer at one or more specified times during the trading day in order to generate one or more orders of identified prices and sizes at which execution may occur immediately ("orders"). Such

¹⁵ According to the Exchange, the PCX specialists may also submit Profiles based on their own proprietary trading strategies, in addition to Profiles reflecting public limit orders on their books. To the extent that a PCX specialist chooses to represent a proprietary trading interest in its designated security by submitting a Profile, that particular Profile will have lower time priority than that of the Profile submitted by any other User in the security, thereby preventing the specialist from trading ahead of any agency orders submitted by Users. Time priorities are discussed below.

¹² PCX would have access to all non-member trade information held by a member in order to perform surveillance. Telephone conversation between John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, and Michael Walinskas, Senior Special Counsel, Division of Market Regulation, SEC, Sept. 4, 1997.

¹³ 17 CFR 240.10a-1.

¹⁴ Letter from John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated August 29, 1997.

processing would involve a series of high-speed calculations ("Cycle"). Cycles would be based on a computer algorithm that is designed to measure and rank all relevant mutual satisfaction outcomes by matching individual coordinates from intersecting Buy Profiles and Sell Profiles. The matching algorithm of the OptiMark System is intended to compute optimal trade results for Users based on their different willingness to trade across a wide range of price and size. A buy coordinate and a sell coordinate, each with a full satisfaction value of 1, would be matched, based on price, standing, time of entry, and size. If one or both coordinates have a partial satisfaction value of less than 1 (but greater than 0), they would be matched, generally based on the mutual satisfaction value—that is, the product of the specific satisfaction values associated with the buy coordinate and sell coordinate.

The Exchange has represented that Profiles would be processed according to the following terms concerning matching eligibility restrictions and priority principles:

1. *Eligibility Restrictions.* At commencement of a Cycle, each individual coordinate with a non-zero satisfaction value from all buy Profiles and all sell Profiles received by the OptiMark System (including CQS Profiles) in a given PCX Security would be grouped into the Buy Profile Data Base or the Sell Profile Data Base, respectively. Each individual coordinate, no matter how small or large in the corresponding size, from either Profile Data Base would be eligible to be matched with one or more coordinates from the other Profile Data Base and would result in one or more orders, provided that:

1.1 No buy and sell coordinates could be matched in violation of any applicable User instructions for the respective Profiles, including: (a) The maximum quantity associated with the Profile, (b) any boundary conditions restricting the aggregate number of shares that may be bought or sold at a particular price or size range, and (c) the restrictions on any potential sale or purchase through ITS; and

1.2 No buy and sell coordinates could be matched from contra CQS Profiles.

1.3 No buy and sell coordinates could be matched at a price inferior to that of another coordinate with standing (as defined below) that is eligible for matching. A buy (sell) coordinate has Standing if: (a) It has 1 satisfaction value and (b) all coordinates having the same price and a smaller size, down to and including the minimum trading increment (100 shares), are included in the associated Profile at 1 satisfaction value; provided, however, that no coordinate from a Profile containing any boundary conditions restricting the aggregate number of shares

that may be bought or sold at a particular size range has Standing. Each coordinate from a CQS Profile would have Standing. By contrast, no coordinate from a Profile submitted by a User on an "all-or-none" basis would have Standing.

2. *Priority Principles.* The methods for considering potential matches between buy and sell coordinates in the Profile Data Bases would vary, depending on whether both coordinates represent satisfaction values of 1 or less than 1. As a result, these would be two separate stages of a Cycle:

2.1 *Aggregation Stage.* The OptiMark System initially would process eligible buy and sell coordinates in the Profile Data Bases, each with the full satisfaction value of 1 only. At this stage of calculation ("Aggregation Stage"), smaller-sized coordinates may be aggregated to build sufficient size to be matched with larger-sized coordinates to generate orders in accordance with the following rules of priority, subject to the applicable eligibility restrictions:

(A) *Price aggressiveness.* A coordinate with a more aggressive price (i.e., a higher price for a buy coordinate and a lower price for a sell coordinate) would have priority over coordinates with less aggressive prices.

(B) *Standing.* Among the coordinates with the same price, a coordinate with Standing would have priority over all other coordinates without Standing.

(C) *Time of entry.* Among the coordinates with the same price and Standing, the time of the entry of the associated Profile would determine relative priority, with earlier submissions having priority. All Profiles submitted by Users would be appropriately time-stamped with a unique serial number when received by the OptiMark System; provided, however, that the effective time of entry for any Profile submitted by a PCX specialist representing proprietary trading interest in the specialist's designated security would fall behind that of a Profile submitted by any other User for that security. Because each CQS Profile would be generated from the relevant market's most current quotation prevailing at the time of commencement of a Cycle, the effective time of entry of a CQS Profile would be later than that of any other Profile submitted by a User, including a PCX specialist's proprietary trading in the specialist's designated security.¹⁶

(D) *Size.* Among the coordinates with the same price, standing and time of entry, priority would be determined by size, with larger sizes having higher priority.

2.2 *Accumulation Stage.* Upon completion of the Aggregation Stage, the OptiMark System would consider potential matches between eligible buy coordinates and sell coordinates in the Profile Data Bases where one or both parties have less than 1 (but greater than 0) satisfaction values. At this stage of calculation ("Accumulation Stage"), only those buy and sell coordinates with the same associated price and size would be matched to generate orders in accordance with the following rules of

priority, subject to the applicable eligibility restrictions:

(A) *Mutual satisfaction.* A potential match with a higher mutual satisfaction value (the product of the two satisfaction values) would take precedence over other potential matches with lower mutual satisfaction values.

(B) *Time of entry (based on the earlier Profile).* Among the potential matches with the same mutual satisfaction, the match with the earlier time of entry, as determined initially by the effective time of entry assigned to the earlier of the buy and sell Profiles involved (the "earlier Profile"), would have priority over other potential matches.

(C) *Size.* Among the potential matches with the same mutual satisfaction and time of entry for the earlier Profile, priority would be given to one with a larger size.

(D) *Time of entry (based on the later Profile).* Among the potential matches with the same mutual satisfaction, time of entry (for the earlier Profile), and size, the match with the earlier time of entry, as determined this time by the effective time of entry assigned to the later of the buy and sell Profiles involved (the "later Profile"), would have priority over other potential matches.

(E) *Price assignment.* In regard to all remaining ties between potential matches, which would consist solely of the coordinates for a single pair of buy and sell Profiles from two Users that may be matched with the same mutual satisfaction, time of entry and size, but at different prices, priority would be given to the match at a price more favorable to the User whose Profile has the earlier time of entry. By way of example, among the last potential matches remaining at the price of 10 and also at 10 $\frac{1}{8}$, if the sell Profile is the earlier Profile, then the match would take place at the price of 10 $\frac{1}{8}$. The Commission notes that two or more Profiles that are entered into the OptiMark System representing the same number of shares may result in executions at differing prices depending on the other information and conditions entered into the System.

The Exchange has represented that, for purposes of the PCX Application, the specific times at which Profiles would be centrally processed would vary, depending on the security involved. No Cycle, however, would be scheduled until after the opening of the PCX market for any such security. Similarly, no Cycle would be scheduled at or after the closing of the PCS market for that security. The maximum frequency with which Cycles may take place throughout the trading day would be every 90 seconds, while the minimum would be once a day.

The Exchange has represented that the exact frequency of Cycles as to any given PCX Security would be determined by OSI, taking into account the general characteristics of the security (e.g., trading volume, price, and number of shareholders), the associated Profile flow over a period, and the current level of interest expressed by

¹⁶ See Amendment No. 3, *supra*, note 7.

Users. From time to time, OSI may alter the frequency of Cycles in response to subsequent developments. PCX has represented that OSI will consult with PCX prior to altering the frequency of any Cycle.¹⁷ Any change in the frequency of Cycles would be effective upon three days' advance notice to Users. Such notice would be provided electronically, using the same telecommunications linkage and protocols available to Users for submitting Profiles. At all relevant times, Users would be fully informed as to when the next Cycle in a particular PCX Security would take place.

The Exchange would assure that the frequency of Cycles remains commensurate with the financial community's need and demand for the trading service. In addition, the Exchange would assure that the PCX Interfaces and the OptiMark System have sufficient capacity in place to handle any material increase in the volume of data prior to implementing a change in the frequency of Cycles.

Order Execution and Reporting

The Exchange would make available the necessary PCX Interfaces to permit orders in PCX Securities from the OptiMark System to be executed, either on the Exchange or on other market centers participating in ITS through the appropriate Exchange communications linkage. The Exchange would permit one or more pairs of orders resulting from intersection of the Profiles submitted by Users (including PCX specialists and floor brokers) to be routed and executed on the Exchange. Every trade resulting from the execution of a pair of orders on the Exchange would be appropriately reported, by way of the traditional Exchange linkage to the CTS processor for dissemination, in the sequence in which orders are generated from the Cycle. The Exchange would report these trades, similar to the way it currently reports other trades in PCX Securities to the CTS. Accordingly, consistent with the existing reporting practices, a series of orders generated from a single Cycle for the same seller with different buyers at an identical price would be printed on the Tape as one transaction. In general, the report for any transaction resulting from the PCX Application would not be distinguished on the Tape from the trade report of any other order executed on the PCX floor.

As for one or more orders representing matched coordinates from CQS Profiles, and other contra Profiles, the Exchange would submit an ITS commitment reflecting each such order and seeking execution on market centers other than PCX. Every ITS commitment would be sent under the give-up of the relevant member User or the Designated Broker, by way of the traditional Exchange linkage to the ITS, in the sequence in which orders are generated from the Cycle. Each ITS commitment would be assigned a "T-1" (one minute) time period as specified in the ITS Plan. The Exchange envisions sending ITS commitments resulting from the PCX Application in the same way other ITS commitments are currently sent from the Exchange. According to the Exchange, ITS commitments resulting from the PCX Application would not be distinguishable from other ITS commitments.

The Exchange would continue to apply all existing rules governing trading on its equity trading floor. For example, market orders routed from members to the Exchange would continue to be executed in the same manner. Similarly, ITS commitments received from ITS participants other than PCX would be executed against the Exchange's prevailing quotations as specified under the ITS Plan. As for limit orders, PCX specialists and floor brokers would be afforded an additional (but not alternative) opportunity to fill such interest through the PCX Application. To the extent that the Exchange specialists and floor brokers submit Profiles to the OptiMark System based on customer interest in their books, the handling of any such Profiles and any resulting trade executions through the PCX Application would be fully consistent with the parameters under which public limit orders are currently filled.

Moreover, PCX specialists would remain fully responsible for managing their limit order books. Accordingly, if a specialist elected not to reflect a customer limit order in the OptiMark System, it would remain accountable for execution at any more favorable price that could have been obtained if such order were processed through the PCX Application. In such a case, consistent with the Exchange's existing floor procedures and practices, the specialist would be required to satisfy or cause to be satisfied the customer limit order so held, either at the limit price specified, or at any better price generated by the Application. PCX has represented that this guarantee is limited to customer limit orders booked prior to the commencement of a Cycle. Therefore,

orders booked after the commencement of a Cycle would not be guaranteed an execution at prices obtained as a result of such Cycle.

In Amendment No. 3 to its filing, PCX clarified that, even if the specialist does not submit a Profile for a limit order in its book, the limit order will receive "the limit price or a better price if one occurred in that cycle, up to the amount of the order or orders executed in OptiMark."¹⁸

Specifically, after a Cycle of the Application is completed, the Application sends the orders to the PCX floor in a batch. The batch of orders, which will be automatically executed, "will be in a specific, deterministic order, as defined by the Aggregation and Accumulation Stage"¹⁹ (discussed above). According to PCX, the order of execution will be provided to the specialist, in the same manner as executions performed in another market, such as NYSE. The specialist will have, out of that batch of executions resulting from a Cycle, the prices and size of each execution. If at the beginning of a Cycle a specialist has a limit order in the book that was not reflected as a Profile in the Application, and, as a result of orders generated through the Application, the booked order becomes eligible for execution, the price that will be given to the booked order will be based upon the best price that occurs out of the batch of orders generated by the Application, up to the size of the booked order not entered into the Application as a Profile.

The Exchange presented the following example: There is a booked order to buy 1,000 shares with a 10 limit price, and the specialist does not express the order as a Profile in the Application. The immediately succeeding Cycle of the Application generates orders resulting in transactions at the following prices: 1,000 at 10 $\frac{1}{8}$, 500 at 10, and 1,000 at 9 $\frac{7}{8}$. Without the existence of the Application, an execution in the same security on the PCX at 10 would trigger an execution of the booked order at 10. With the implementation of the Application, the batched transactions resulting from a Cycle would be viewed as a unit for purposes of determining the price at which the booked order should be filled. The specialist, therefore, would look for the best price resulting from the Cycle in determining the price at which to fill the booked order. In this case, the transaction resulting at a price of 9 $\frac{7}{8}$ for 1,000 shares would be the determining price, and the specialist would be obligated to fill the order at

¹⁷ Telephone conversation between John C. Katovich, Senior Vice President, General Counsel, and Director of Legal Affairs, PCX, and Michael Walinskis, Senior Special Counsel, Division of Market Regulation, SEC, Sept. 4, 1997.

¹⁸ See Amendment No. 3, *supra*, note 7.

¹⁹ *Id.*

9 $\frac{7}{8}$ s. If, on the other hand, the Cycle resulted in a series of transactions that included only 500 shares at the prices stated above, and the specialist nevertheless had a booked limit order for 1,000 at 10 (which was not entered into the Application), the specialist would be obligated to fill the first 500 shares of the booked order at 9 $\frac{7}{8}$ s and the remaining 500 shares at 10, the next best price generated by the Cycle.

In Amendment No. 3, PCX provided an example of how limit orders booked with PCX specialists would interact with the Application. In the example, a specialist would have two booked limit orders at buy, the first for 1,000 shares, and the second for 500 shares, both at a price of 30. The example assumes that the specialist did not enter the 1,000 share order into the Application, but the specialist did enter the 500 share order into the Application as a Profile. In the example, the next Cycle of the Application resulted in a transaction of 29 $\frac{1}{2}$ for the 500 share order entered into the Application as a Profile. In such a case, the specialist would be required to fill both orders at 29 $\frac{1}{2}$.

In Amendment No. 3, PCX also further clarified the manner in which PMP would operate in connection with the Application. Generally, according to the PCX,

[i]f an order is received and specifically marked PMP (primary market protection), this means that the firm sending the order has usually requested that the order only get filled if within the range of the designated "primary" market (usually the NYSE and AMEX). In such a case, the specialist is operating under the understanding that the order will not get filled outside the "primary" market range.²⁰

In order to ensure that PMP orders can be integrated into the Application, PCX represented that:

during regular "primary" market trading hours, an order specifically marked PMP will have to be treated just like any other booked order when executions result from OptiMark matches, even if the "primary" market range has not traded at that price. Similarly, a PMP order reflected into OptiMark as a profile, which is matched in OptiMark and results in an execution, will require that the PMP limit order be filled, even if the price is out of range from the * * * otherwise existing "primary" market, however defined.²¹

²⁰ See Amendment No. 3, *supra*, note 7, at 2.

²¹ *Id.* PCX will codify this clarification through a rule amendment with the Commission. In this regard, PCX stated that the amendment "will be consistent with the overall premise that under no circumstance can a specialist accept an execution arising out of orders generated from an OptiMark cycle, without first taking care of any eligible booked orders that were put in the book before the cycle began." *Id.*

PCX will undertake to amend its rules so that the operation of the Application would be considered as an exception to Rule 5.32 regarding the execution of orders marked PMP.

The Exchange has also represented the operation of the PCX Application would be consistent with the Exchange's intermarket price protection obligations under the ITS Plan. The OptiMark System incorporates existing market interest emanating from each of the ITS participant markets to which it is not directly linked in the form of CQS Profiles. Because of the rules of priority for considering potential matches between buy coordinates and sell coordinates from any Profiles (including CQS Profiles), all orders that are priced inferior to the quotations of another market center would be generated and executed on PCX only upon submission of appropriate ITS commitments seeking to reach such better-priced interest. As a result, the Exchange has represented that execution of any such orders on PCX would not violate the trade-through rule under the ITS Plan.

The Exchange has represented that all Users would be informed of executions that take place against the Profiles that they submitted for their own or customer accounts promptly after the trades occur. If an ITS commitment resulting from the PCX Application is canceled or only partially filled, the OptiMark System would notify the relevant User and restore to the Profile the volume of the security represented by the unfilled order. All such reports would be sent electronically, using the same telecommunications linkage and protocols that were used to submit the Profiles initially. Unless specified otherwise by non-member Users in advance, executions would not be reported to relevant Designated Brokers until after the close of the trading day in order to limit market impact and other such adverse effects of non-member Users' trading.

Clearance and Settlement

The Exchange has represented that transactions in PCX Securities resulting from the PCX Application, including any ITS commitment sent to another market center and accepted, would clear and settle in the same way as other transactions occurring on the Exchange floor. All orders generated by the OptiMark System that are executed on PCX or another market center through ITS would be reported and entered into the comparison system on a locked-in basis. Orders generated by the OptiMark System on behalf of a member User and the resulting transactions would be cleared and settled using that member

User's mnemonic (or its clearing broker's mnemonic). Orders generated by the OptiMark System on behalf of a non-member User and the resulting transactions would be cleared and settled using the appropriate Designated Broker's mnemonic (or its clearing broker's mnemonic).

The Exchange or any operator, administrator or licensor of the OptiMark System would not be responsible for any User's failure to pay for PCX Securities purchased or to deliver PCX Securities sold. Neither OTI nor OSI would be deemed to be a party to or a participant in, as principal or as agent, any trade or transaction entered into or otherwise conducted by Users while using the OptiMark System for the purposes of clearance and settlement.

Hours of Operation

The PCX Application would be initially available for execution of orders and routing of ITS commitments during the regular PCX hours after the opening and prior to the closing.²² In the event of a suspension in trading of a security listed or traded on the Exchange, the Exchange would suspend the related trading activities respecting that security through the PCX Application. In addition, the Chairman or, in the Chairman's absence, Chief Operating Officer, or other PCX Officer(s) as the Chairman may designate, may determine that market conditions warrant a market-wide halt pursuant to the Exchange's Policy Statement on Market Closings. Trading on the PCX Application of the OptiMark System would be covered by such a market-wide halt. The Exchange may suspend the trading activities through the PCX Application relating to one or more PCX Securities at any time upon consultation with OTI if deemed necessary and proper to preserve system capacity and integrity.

Audit Trail and Surveillance

The Exchange would maintain, or cause to be maintained, a detailed audit trail of each transaction resulting from the PCX Application, including time sequenced records of Profiles submitted to the OptiMark System, orders resulting from a Cycle, and their execution and reporting through PCX facilities. Such data would be stored and preserved for a period of not less than three years, the first two years in an easily accessible place, to assure that the Exchange has sufficient information for exercising its regulatory oversight.

²² The Exchange's hours are currently 6:30 a.m. (P.T.) to 1:30 p.m. (P.T.).

The Exchange would apply appropriate equity trading surveillance procedures to monitor transactions resulting from the PCX Application.

System Capacity and Integrity

The Exchange believes that the PCX Interfaces and the OptiMark System would provide sufficient capacity to handle the volume of data reasonably anticipated for the PCX Application. The Exchange would have in place security procedures designed to prevent unauthorized access to the PCX Application and to safeguard the PCX Interfaces. The Exchange would obtain similar assurances from OTI and OSI that reasonable security procedures are in place to safeguard the OptiMark System and to protect against threats to the proper functioning of the OptiMark System, including any networks used by the OptiMark System. The Exchange would also obtain appropriate assurances that proper system reliability and system capacity exists to ensure the integrity of the data handled and timely response of the OptiMark computers in connection with the PCX Application.

Fees for the PCX Application

Transactions resulting from the PCX Application would be subject to the Exchange's customary assessment of transaction charges and the Commission's exchange transaction fee under Section 31 of the Act. As a sponsor of the OptiMark System within the meaning of Rule 17a-23 under the Act, OSI, which currently plans to apply to register as a broker-dealer, would be compensated by way of usual and customary commissions, on a cents-per-share-filled basis, for transactions effected by a member User for its own customer accounts through the PCX Application. With respect to transactions effected by a non-member User, OSI would be paid commissions on a similar basis from the relevant Designated Broker.

III. Comments Received

The Commission received fourteen comment letters in response to its request for comments on the PCX proposal.²³ All of the comment letters, except for a letter submitted by the NYSE, supported the PCX's proposal. Letters in support of the proposal were submitted by institutions, broker-dealers (including underwriters, specialists, and retail and clearing brokers), the Treasurer of the State of California, and from academia.

Those submitting letters in favor of the implementation of the OptiMark

System provided various reasons for their support of the PCX proposal. For example, commenters stated that the OptiMark System would provide an alternative to the traditional method of order execution and would be the first system available to allow institutions to use complex trading strategies in a secure environment.

Several commenters stated that the OptiMark System would provide both retail and institutional participants with an improved ability to buy or sell securities in a manner that matches their objectives. Commenters stated that both retail and institutional customers would benefit from better prices.

One broker-dealer, for example, stated that the OptiMark System would enable its retail customers to obtain price improvement derived from a mixture of retail and institutional order flow between PCX floor brokers and specialists. Another stated that the system would be beneficial in allowing for anonymous interaction between retail orders and institutional orders.

In addition, some commenters focused specifically on the confidentiality of the OptiMark System. One commenter noted that, currently, trading interest may be difficult to assess because of concerns about information integrity and the market impact cost of large orders. Another stated that one of the biggest problems that institutions face today is attempting to keep their decisions to buy or sell securities confidential. These and other commenters argued that OptiMark would provide a solution to such problems. One commenter stated that the system would allow a portfolio manager to add qualitative information to each order on a non-disclosed basis.

Several commenters stated that the OptiMark System would promote liquidity, and two commenters stated that the Application would reduce market volatility. Several commenters stated that OptiMark would promote market efficiency and reduce transaction costs by lowering the market impact of trades.

Commenters also argued that the OptiMark System would further the development of the national market system ("NMS") envisioned in the Securities Acts Amendments of 1975,²⁴ and as reflected in Section 11A of the Act.²⁵ One such commenter stated that "OptiMark represents precisely the kind of 'new data processing and communications techniques' that Congress thought when it passed the 1975 Securities Act Amendments would

create the opportunity for more efficient and effective market operations, and would foster efficiency, enhance competition, facilitate the offsetting of customer orders, and contribute to best execution."²⁶ The same commenter stated that OptiMark's operation as a facility of an exchange, "with the accompanying linkage to other markets through the ITS system, should ensure that OptiMark has a positive impact on the national market system as a whole."²⁷

One commenter also stated that OptiMark would promote free market competition and would "erod[e] the private club benefits previously afforded members of dominant exchanges and compel * * * limit order disclosure to the public markets."²⁸

In contrast to the views of the supporting commenters, NYSE submitted a comment letter opposing the PCX rule filing ("NYSE Comment Letter").²⁹ The NYSE asked the Commission not to approve the filing, but to require PCX to further explain and clarify its proposal. In its letter, NYSE expressed several concerns about the possible implementation of the OptiMark System. First, NYSE contended that the system would have the effect of "creating a hidden market" within PCX, which it believed would be detrimental to other trading interest on PCX and to the NMS, and contrary to established PCX auction rules.³⁰ NYSE argued that marketable trading interest processed through the Application would not be exposed to the PCX auction or to the NMS until after a transaction has occurred. In NYSE's view, OptiMark Profiles would constitute orders that should be incorporated into PCX's floor-based trading system. More specifically, NYSE contended that Profiles equal to or better than the price of the then-disseminated PCX quotation should be quoted in the same manner as other orders received by PCX. In addition, NYSE argued that a trade resulting from use of the OptiMark System that is printed on PCX would impose new and additional price protection responsibilities on PCX specialists. NYSE claimed that the PCX filing was silent about the right or obligation of PCX floor brokers to "break up," and provide potential price improvement

²⁶ See Letter from Tim McCarthy, Charles Schwab, *supra*, note 4.

²⁷ See *id.*

²⁸ See Letter from Harold S. Bradley, American Century Investment Management, Inc., *supra*, note 4.

²⁹ See Letter from James E. Buck, NYSE, *supra*, note 4.

³⁰ *Id.* at 2.

²³ See *supra*, note 4.

²⁴ Pub. L. No. 94-29, 89 Stat. 131 (1975).

²⁵ 15 U.S.C. 78k-1.

for, Profiles crossed or matched within the OptiMark System and routed to the PCX floor for execution.

NYSE raised concerns about the potential effect of the Application on PCX's relationship with the ITS with respect to access and liability for clearance and settlement. NYSE stated its belief that the Application's access to ITS would be different from that currently used by PCX for the sending of ITS commitments pursuant to the ITS Plan. NYSE argued that it would be premature for the Commission to approve PCX's filing until PCX has provided the ITS participant markets with a clear and detailed understanding of how PCX intends for OptiMark to access the ITS. NYSE also claimed that PCX was attempting to amend the terms of the ITS Plan to limit PCX's liability beyond the authority set forth in the ITS Plan.³¹

Finally, NYSE stated that the PCX filing did not clearly reflect that all ITS price protection rules would be followed by the users of the Application. NYSE noted that ITS price protection rules specify the obligations of participant members for satisfying trade-throughs, Block Policy trades, and locked markets involving other ITS participant markets, and that these obligations include a requirement to issue ITS commitments to trade. Next, it highlighted that PCX's filing stated that users would be able to "place restrictions on any potential purchase or sale of shares through ITS." ³² NYSE believes this language suggests that a PCX member (or member's customer) could place restrictions on the use of ITS that would ignore the ITS price protection rules. Accordingly, NYSE suggested PCX's filing be amended to note the limitation on a user's right to place limitations on the use of ITS for price satisfaction purposes.

Further, NYSE questioned OptiMark's proposed compliance with the Commission's short sale rule. NYSE noted a letter sent by the PCX to the Commission's Division of Market Regulation in May 1997, requesting

relief from the short sale rule.³³ NYSE stated that an exemption "would not be appropriate for a system such as OptiMark which provides price discovery." ³⁴ NYSE also referred to PCX's proposed amendment to PCX Rule 5.14, which proposed that "[t]he Exchange's short sale rule (Rule 5.18) shall not be applicable to any resulting transaction in the Exchange." ³⁵ NYSE argued that the approval of such a proposed rule would "establish a clear conflict that could lead to inadvertent regulatory violations." ³⁶ NYSE recommended that PCX amend its proposal to delete both PCX Rule 5.14 and the above-quoted proposed language.

On August 1, 1997, PCX submitted to the Commission a letter responding to issues raised in the NYSE Comments Letter.³⁷ In response to NYSE's comment that the Application would create a "hidden market," PCX stated that the Application would operate in a manner consistent with existing principles of the current auction market now in place at PCX as well as at NYSE. PCX represented that "[b]ids or offers announced on the PCX floor or in the specialist's book will continue to be collected and disseminated by the PCX in full compliance with Rule 11AC1-1" under the Act, and that PCX's continuous auction facilities, separate and apart from the periodic auction conducted by the Application, would continue to be available to members.³⁸

PCX argued that "[t]he fact that Profiles will not be disseminated as quotes does not create a hidden market" because the Profiles are analogous to indications of interest, and not bids and offers.³⁹ PCX further argued that the Application represents a periodic call market facility and that quotes in such market have no meaning because trading interest remains a generalized expression of interest until it is processed during the call. PCX argued that no Profile is eligible for execution until the time of the call, in contrast to a quote, which is a firm bid or offer available for execution at any time. In this regard, PCX believes that the display of any Profile in an open quote

stream would contradict the desire of Users submitting Profiles and would impair the integrity of the quote system because individual Users would represent multiple and differing price values for any given buy or sell interest. Thus, PCX stated that it should not be required to display in the PCX quotation User Profiles, including those coordinates with a satisfaction value of 1.

In response to the NYSE argument that the Application would impose new price protection responsibilities on PCX specialists, PCX stated that although the Exchange would require its specialists, under PCX Rule 5.32(a), to honor their obligations for executions at the same or better prices that occur as a result of the Application, this requirement would not constitute a new obligation. As an example, PCX outlined how PCX specialists guarantee the price of executions that occur on the "other city floor" ⁴⁰ of the PCX, noting that under certain circumstances, a PCX specialist may be obligated to fill an order at a price obtained from the "other" PCX floor. PCX noted that the guarantee requirements imposed on PCX specialists regarding transactions effected through the Application will likely influence them to reflect frequently their book orders in the OptiMark system, although they would not be obligated to do so. Further, if a specialist did not honor its obligations to execute an order, based upon an execution that occurs in the primary market or within the PCX market, the specialist would be found to be in violation of existing PCX rules.

PCX also disagreed with the NYSE's comment that the PCX proposal does not comply with PCX's crossing rules, specifically PCX Rules 5.14 (a) and (b). According to PCX, under these rules members are responsible for assuring that all existing bids or offers, at or better than the cross price, are filled at their limits. PCX argued that although the OptiMark System would help a User find other trading interest through the central processing of Profiles, this is not the same as a cross transaction on the Exchange floor, where both sides of the trade are brought to the specialist's post by a broker. PCX emphasized that when coordinates from Profiles happen to match at the time of the call, it is fortuitous and can not be considered a cross as defined in either PCX or NYSE rules. PCX further stated that when two Profiles with overlapping coordinates give the appearance of a cross, the processing of these Profiles against other

³¹ The NYSE cited, in particular, the language in the PCX's filing that states:

In no event will the Exchange or any operator, administrator or licensor of the OptiMark System be responsible for any User's failure to pay for the PCX Securities purchased or to deliver the PCX Securities sold. Neither OTI nor OSI will be deemed to be a party to or a participant in, as principal or agent, any trade or transaction entered into or otherwise conducted by Users while using the OptiMark System for the purposes of clearance and settlement.

Letter from James E. Buck, NYSE, *supra*, note 4, at 5-6.

³² *Id.* at 6.

³³ See Letter from John C. Katovich, Senior Vice President and General Counsel, PCX, to Richard R. Lindsey, Director, Division of Market Regulation, SEC, dated May 19, 1997 ("PCX May 19 Letter").

³⁴ See Letter from James E. Buck, NYSE, *supra*, note 4, at 4. NYSE also noted it would not generally comment on this because it understood that Commission staff would not grant the requested exemption from Rule 10a-1 under the Act. *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ See Amendment No. 1, *Supra*, note 5.

³⁸ *Id.* at 2.

³⁹ *Id.*

⁴⁰ The PCX has equity trading floors both in San Francisco and Los Angeles.

trading interest in the PCX Application may not result in a match between the two Profiles. Rather, the priorities established by the Application could effectively "break up" any such potential match.

With respect to NYSE's comment on ITS access, the Exchange argued that the Application would not change the method of system access in any manner that calls for an ITS Plan amendment. Instead, the Exchange stated that the Application would be an additional exchange facility, through which the Exchange would be able to honor its existing ITS commitments. The Exchange emphasized that the Application would merely provide more convenient electronic access for the benefit of its members and their customers, and as such, the Application would "complement one 'example' of system access described in Section 6 of the ITS Plan through added flexibility, thereby promoting the increased use of ITS through information and telecommunications technology innovation, all as intended by the ITS Plan and as required by the Commission under Section 11A of the Exchange Act."⁴¹

With respect to NYSE's argument that the PCX filing would "effectively amend the terms of the ITS Plan to limit PCX's liability beyond the terms specified in the Plan," PCX responded that the filing would not have such an effect; similar limitations on liability have not been construed or applied so as to limit an ITS Participant's contractual obligations arising under Section 9 of the ITS Plan. PCX further stated that NYSE itself limits its liability for any damages sustained in connection with the use of its facilities, citing NYSE Constitution, Article II, Section 6.

PCX strongly disagreed with NYSE's comment that PCX's proposed User restrictions on potential purchases or sales of shares through the ITS would have the effect of obviating the ITS price protection rules, stating that the Exchange "adheres strictly to the ITS price protection rules."⁴² The Exchange stated that its filing "repeatedly provides that no orders may be executed on the Exchange at a price inferior to that of other outstanding trading interest with standing, which includes CQS Profiles derived from the quotes of other ITS Participants."⁴³ The Exchange also stated that Users placing restrictions on any potential purchase or sale of shares through ITS would be required to forgo any potential transactions that would

cause a trade-through. The Exchange concluded that permitting a User to place limitations on the use of ITS at the User's own risk is consistent with the ITS plan because it does not implicate the ITS price protection rules.

The PCX letter also mentioned the PCX's May 1997 request for exemptive relief from the short sale rule and noted that it understood that such relief would not be granted. Accordingly, the PCX submitted a proposed amendment to PCX Rule 15.3(b), which (as modified by a subsequent amendment) would add the following language to the Rule:

and provided further that no Orders designated as "sell short" may be generated for execution at a price: (i) Below the price of the immediately preceding match (or the last sale price reported on a consolidated transaction reporting system immediately prior to commencement of the Cycle in the case of the initial match of that Cycle) or (ii) at such price unless such price is above the next preceding different price.⁴⁴

On August 20, 1997, NYSE submitted to the Commission a second comment letter responding to issues that the PCX raised in Amendment No. 1.⁴⁵ In its letter, NYSE expanded upon points raised in its initial comment letter. For example, NYSE again raised the "hidden market" issue. NYSE argued that the PCX was proposing "to sponsor two markets (its 'regular' market and the OptiMark cycles) with minimal interaction between the two."⁴⁶ NYSE also challenged OptiMark's claim that the Cycles would constitute a periodic call market because Cycles would be as frequent as every 90 seconds. As a result, NYSE argued, Users could enter a priced order into a "nearly-continuous auction, without disclosing the order to the regular market, even if the order matches or improves the national best bid and offer."⁴⁷ NYSE argued that this activity would stand in direct conflict with recent Commission efforts to integrate all trading interest in the national market system, whether through electronic communication networks or otherwise.

In addition, NYSE reiterated that the Application would be inconsistent with PCX's own auction rules, claiming that orders and executions resulting from the Application would not be integrated with other PCX trading interest and, as such, would not be like other PCX executions. NYSE stated that PCX's rules require that all orders be

integrated into the PCX auction and interact with other trading interest taking place on the PCX floor. NYSE argued that, contrary to PCX's auction rules, an order entered on the PCX after the commencement of a Cycle of the Application would "not interact with an OptiMark 'order' that is 'routed and executed on the [PCX], even if the more recent PCX order is at a better price or has priority over the OptiMark 'order.'"⁴⁸

In addition, NYSE argued that the PCX's proposed amendment regarding its intended compliance with the Commission's short sale rule, as explained in the PCX's Amendment No. 1, is inconsistent with the wording and purposes of the rule. NYSE characterized PCX's proposal as prohibiting short sales in the Application on minus ticks or zero minus ticks based on the last "match" in the Application, and that the Application would rely on the last transaction reported to the CTS only for the initial Cycle. NYSE argued that Rule 10a-1, by contrast, regulates short selling based on consolidated last sales, giving an exchange an option of using the last sale on that exchange. NYSE therefore argued that an exchange "cannot regulate short sales based on sales in only one component of an exchange's trading system."⁴⁹

NYSE also addressed the Application's access to, and liability for clearance and settlement through, the ITS. With respect to access, NYSE took issue with the PCX's statement that the Application "will complement one 'example' of system access" described in the ITS Plan. NYSE argued that this statement "raises serious questions of access to NYSE market and to the markets of the other ITS Participants."⁵⁰ NYSE stated that PCX intends to make a detailed presentation at an ITS Committee meeting in September 1997, and argued that it would be premature for the Commission to act on the PCX's filing before the meeting and further consideration of the issue.

With respect to the PCX's proposal regarding liability for clearance and settlement with respect to the Application, NYSE restated its earlier position that the PCX's proposal is inconsistent with Section 9 of the ITS Plan, which requires each Participant to assume responsibility for settling certain uncompared ITS trades. NYSE argues that the PCX's proposal attempts to amend the ITS Plan to limit the PCX's liability beyond the terms of the Plan.

⁴⁴ *Id.* at 1-2.

⁴⁵ See Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated Aug. 20, 1997 ("NYSE Second Comment Letter").

⁴⁶ *Id.* at 1.

⁴⁷ *Id.*

⁴⁸ *Id.* at 2.

⁴⁹ *Id.* at 3.

⁵⁰ *Id.* at 4.

⁴¹ See Amendment No. 1, *supra*, note 5, at 4.

⁴² *Id.* at 5.

⁴³ *Id.*

On August 29, 1997, PCX submitted to the Commission two letters supplementing the filing and further addressing issues raised by the NYSE.⁵¹ PCX stated that it is incorrect to characterize an order generated by an Optimark cycle as a "cross" given that, under PCX Rule 5.14(a), a cross transaction is "a transaction in which a member effects both the purchase and sale."⁵² PCX submitted that most matches resulting from a Cycle would be based on trading interest reflected in Profiles submitted by two different members, and thus would not be crosses involving the same member. Although PCX conceded that the same member could submit both buy and sell Profiles that could result in a matched order, it pointed out that the member would have no control or influence in determining the outcome of such a match. PCX concluded that the presence of member intermediation and trading discretion is essential to the definition of "cross" as it is understood and applied in the context of continuous auction trading.⁵³

In response to NYSE's claim that PCX floor brokers representing customer interest could "miss the market" if they chose not to use Optimark, PCX noted that such an outcome was no different than the situation where a floor broker either routes a customer order to another market or is not present in the trading crowd when a cross is announced.⁵⁴

In the PCX ITS Letter, the PCX clarified its continued responsibility to settle trades effected through the PCX Application, pursuant to the terms of the ITS Plan. Specifically, PCX stated that it did not intend to modify any PCX members' obligations under the ITS Plan nor to modify the Exchange's obligation under the Plan to ensure settlement of trades effected via the PCX Application.⁵⁵

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and in particular, the requirements of Section 6(b) (5).⁵⁶ The Commission finds that the Exchange's proposal to establish rules to implement the PCX Application of the Optimark

System would promote the Commission's mandate under Section 6(b)(5) to remove impediments to and perfect the mechanism of a free and open market and a NMS, while protecting investors and the public interest. In addition, the Exchange's proposal with respect to the PCX Application is consistent with the Section 6(b)(5) requirements that rules of an exchange be designed to prevent fraudulent and manipulative acts, to promote just and equitable principles of trade, and are not designed to permit unfair discrimination among customers, issuers, or broker-dealers.⁵⁷

In addition, the Commission finds that the proposed rule change is consistent with the requirements of Section 11A of the Act.⁵⁸ The Commission believes that the proposed Application of the OptiMark System would further the purposes of Section 11A of the Act and the development of a NMS by promoting economically efficient execution of securities transactions, fair competition among markets, the best execution of customer orders, and an opportunity for orders to be executed without the participation of a dealer. The PCX Application provides a new and potentially more efficient way for the Exchange to match and execute trading interest. The Application appears principally designed to meet the demands of sophisticated portfolio managers and other market professionals implementing complex trading strategies. These market participants often require instantaneous access to the market, and desire to minimize the market impact of their transactions through the expression of varied trading interests on a confidential basis. At the same time, the Application is designed to allow retail customers, through member Users, to interact with institutional trading interests.

The PCX Application is likely to promote competition among market centers because it has the potential to attract new market participants and to increase order flow to the Exchange. By attracting order flow, the Application may provide a new and enhanced source of liquidity for investors. Further, as noted in the majority of the thirteen comment letters that supported the proposal, both institutional and retail investors should benefit from the Application insofar as their expressions of trading interest are represented in the

OptiMark System and are executed on the Exchange. As a result, the Application could enhance the ability of investors to have their orders executed on the PCX. Moreover, the Application would increase the ability of investors' orders to interact directly with other investors orders on the PCX.

The Commission has historically encouraged exchanges to integrate new data communications and trade execution mechanisms into their markets in furtherance of the development of the NMS.⁵⁹ The Commission, for example, approved the fully computerized National Securities Trading System ("NSTS") of the Cincinnati Stock Exchange, the MAX and SuperMAX Systems of the Chicago Stock Exchange, and the CAES operated by Nasdaq.⁶⁰ In fact, the PCX Application of the OptiMark System shares many of the characteristics of the Chicago Stock Exchange's Chicago Match System, which was approved by the Commission in 1994.⁶¹ Like the

⁵⁹ In 1982, when instating the Cincinnati Stock Exchange's NSTS as a permanent program, the Commission stated:

In mandating the development of a NMS, Congress expressly stated that "[n]ew data processing and communications techniques create the opportunity for more efficient market operations." . . . In carrying out Congress' mandate, the Commission has taken an evolutionary approach by encouraging the securities industry to take the primary initiative in fashioning trading mechanisms which are consistent with the goals of a NMS. The Commission believes that, as a general matter, the industry has responded well to changing economic and technological demands by attempting to integrate state of the art data processing and communications technology to develop many new trading systems which have advanced the objectives of a NMS. In this respect, the Commission believes that ITS, the NASD's [National Association of Securities Dealers'] Computer Assisted Execution System ("CAES") and the NSTS represent constructive approaches to integrating trading in physically dispersed locations. (citations omitted)

Securities Exchange Act Release No. 19315 (Dec. 9, 1982), 47 FR 56236 (Dec. 15, 1982).

⁶⁰ See, e.g., Securities Exchange Act Release No. 19315 (Dec. 9, 1982), 47 FR 56236 (Dec. 15, 1982) (Commission approval to terminate the NSTS as an experimental program and extend its duration for an indefinite period of time); Securities Exchange Act Release No. 12451 (May 14, 1976), 41 FR 20932 (May 21, 1976) (Commission approval of the MAX system to operate on a permanent basis); Securities Exchange Act Release No. 32631 (July 14, 1993), 58 FR 39069 (July 21, 1993) (Commission approval to operate the SuperMAX system on a permanent basis); Securities Exchange Act Release No. 17601 (Mar. 4, 1981), 46 FR 16171 (Mar. 11, 1981) (Commission Notice of the NASD filing of a proposed rule change for the establishment of CAES); Securities Exchange Act Release No. 17744 (Apr. 21, 1981), 46 FR 23856 (Apr. 28, 1981) (Commission order to implement an automated interface between the ITS and CAES); and Securities Exchange Act Release No. 18713 (May 6, 1982), 47 FR 20413 (May 12, 1982) (implementing ITS/CAES interface and operations).

⁶¹ Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1994). The

⁵¹ See PCX Floor, Letter and PCX ITS Letter, *supra*, note 6.

⁵² PCX Floor Letter, *supra*, note 6, at 1.

⁵³ *Id.*

⁵⁴ *Id.* at 2.

⁵⁵ PCX ITS Letter, *supra*, note 6. See also, PCX Rule 5.23.

⁵⁶ 15 U.S.C. § 78(f)(b)(5).

⁵⁷ In approving the proposal, the Commission has considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. § 78c(f).

⁵⁸ 15 U.S.C. § 78k-1.

proposed Chicago Match System, the PCX Application blends some of the features of a call market with the continuous auction of the PCX floor. The operation of such a hybrid system will differ in important respects from the traditional structure of a trading floor. For the reasons discussed below, however, the Commission does not believe that these differences would cause the PCX Application to violate the provisions of the Act.

First, the Commission believes that the Application, operating as a facility of an exchange, would have the ability and capacity to carry out the regulatory purposes of the Act.⁶² As part of its obligations under the Act and pursuant to its own rules, the Exchange would conduct all necessary surveillance of the operation of and trading through the Application.⁶³ The Exchange has also represented that the Application would have a full audit trail capability, adequate computer capacity to handle and process User Profiles and order flow, and adequate computer security to ensure the safety and confidentiality of User transmission.⁶⁴

Second, contrary to the NYSE's assertion, the Exchange is not operating a hidden market in violation of the Firm Quote Rule.⁶⁵ Specifically, the Commission does not believe that the PCX Application violates the Firm Quote Rule. The Firm Quote Rule, among other things, requires exchanges

to collect bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers or dealers for subject securities, and make them available to quotation vendors.

A bid or offer is defined in the Firm Quote Rule as the "bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer."⁶⁶ In order to constitute a bid or offer, therefore, the underlying trading interest must have been communicated to at least one other potential counterparty. Bids and offers are intended to attract other parties to deal with the person publishing the bid or offer at the quoted price. For example, the Commission recently deemed the entry of priced orders into an electronic communications network ("ECN") to be bids and offers where these orders were widely disseminated to other parties.⁶⁷ In contrast, the essence of the Application is its anonymity. Only the Application is aware of the potential trading interest until trades occur. The PCX represents that the Application would "not permit any interactive communication among Users whatsoever for any solicitation of trading interest (not even on an anonymous basis)."⁶⁸ The PCX further represented that the Application "differs fundamentally from any 'hit or take' or 'interactive' trading system,

which allows the display of order price and size levels by a subscriber for others to act on."⁶⁹ The Commission agrees with the PCX representation that the Application "is *not* a mechanism by which system subscribers (1) broadcast prices to other system subscribers and (2) trade with one another at those prices," like an exchange or ECN.⁷⁰ Accordingly, the Commission believes that the Application as proposed would not violate the Firm Quote Rule and would not fall within the status of an ECN.

Moreover, Profiles, unlike bids and offers, are conditional until they are processed in a Cycle. In this way, Profiles are analogous to indications of interest or CAP orders, neither of which are displayed in exchanges or on Nasdaq. The terms "bid" and "offer," as defined by the Firm Quote Rule, do not include "indications of interest."⁷¹ A Profile is only a generalized expression of interest with conditions attached and is not eligible for execution until the completion of the Cycle. Profiles entered into the PCX Application can be revised and cancelled at any time prior to commencement of the next scheduled Cycle.

Further, the Commission does not believe that the PCX Application would create a hidden market within PCX. The Commission particularly disagrees with NYSE's suggestion that PCX's proposed non-dissemination of Profiles to PCX's equity floor and other exchange markets is contrary to the goals of the NMS. Rather, the Commission believes that the unique design of the Application warrants a non-traditional approach in determining whether to require the dissemination of trading interest expressed through operation of the Application. The Application reflects the efforts of PCX to establish a trading system that blends elements of a call market with a continuous auction market, with anonymous Profiles being continuously entered and cancelled until the next scheduled periodic call market (performing a Cycle). The failure to disseminate Profiles does not provide any other market participant with an unfair market advantage as a result of seeing the trading interest that is not shown to others. Any User only knows its own Profile; it has no special access

PCX Application differs from Chicago Match in that it is a periodic, rather than a unitary, call market.

⁶² The PCX Application is properly regulated as a facility of an exchange, as defined in Section 3(a)(2) of the Act. The PCX Application of OptiMark would use the PCX's premises, property, and services for effecting and reporting transactions. For a recent discussion of the classification of an electronic communication and matching system as a facility of an exchange, see Securities Exchange Act Release No. 35030, *supra*, note 61 (concerning the Chicago Match System).

OSI, which plans to register as a broker-dealer and comply with Rule 17a-23 under the Act, would be responsible for operating portions of the PCX Application for the Exchange and would receive commissions from Users for transactions. The Exchange has represented that it will submit any changes to this structure to the Commission as a rule filing.

In addition, OTI expects to offer other exchanges trading services based on the OptiMark System technology. If another national securities exchange chooses to use the OptiMark System, it would be required to file a separate rule filing under Section 19(b) of the Act.

⁶³ Further, the Exchange will ensure that the Application complies with all trading halts and trading suspensions.

⁶⁴ As with any other exchange application, the Commission expects to conduct a full EDP review of the Application and its operations. See, e.g., the Commission's Automation Review Policy guidelines, Securities Exchange Act Release No. 27445 (Nov. 16, 1989), 54 FR 48703 (Nov. 24, 1989), and Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

⁶⁵ 17 CFR 240.11Ac1-1.

⁶⁶ See CFR 240.11Ac1-1(a)(4).

⁶⁷ The term "electronic communications network" means, for the purposes of 17 CFR 240.11Ac1-1(c)(5), "any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part; except that the term electronic communications network shall not include: (i) Any system that crosses multiple orders at one or more specified times at a single price set by the ECN (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by participants outside of such times; or (ii) Any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal, other than riskless principal." See 17 CFR 240.11Ac1-1(a)(8). Rule 11Ac1-1(c)(5)(i) provides that the "[e]ntry of any priced order for a covered security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such order shall be deemed to be: (A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to paragraph (c) of this section for at least the minimum quotation size that is required by the rules of the market maker's exchange or association if the priced order is for the account of a market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer; and (B) A communication of a bid or offer to a quotation vendor for display on a display device for purposes of paragraph (c)(4) of this section." 17 CFR 240.11Ac1-1(c)(5)(i).

⁶⁸ See PCX May 19 Letter, *supra*, note 33, at 8.

⁶⁹ *Id.* at 8-9.

⁷⁰ *Id.* at 9.

⁷¹ Rule 11Ac1-1(a)(4) provides that the terms "bid and offer" mean "the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, *but shall not include indications of interest.*" (emphasis added) 17 CFR 240.11Ac1-1(a)(4).

to other Users' Profiles. Moreover, users have no control or influence in determining the outcome of a match, other than through the construction of their own Profiles.

In addition, the Commission believes that dissemination of Profiles would likely be very difficult, given that Profiles represent contingent trading interest at different prices, share amounts, and satisfaction levels. Any accurate dissemination of Profiles, other than Profiles containing only a satisfaction value of one, would need to be expressed in a three-dimensional format, which could create confusion for investors.

Third, the Commission believes that trading interest on the PCX floor would be adequately integrated into the PCX Application. Specifically, specialists and floor brokers would be able to reflect customer trading interest by entering Profiles into the PCX Application. In addition, if a specialist does not submit a limit order to the Application, the Exchange would require that specialist to guarantee the execution of the limit order at the price of an order derived from a Cycle that is priced at or better than the limit order's price, up to the amount of shares executed as a result of the particular Cycle.⁷² Floor brokers, similarly, would remain subject to best execution obligations. The NYSE has pointed out the possibility that, during a small window of a few seconds, if a limit order were sent to the Exchange immediately following the commencement of a Cycle, this order would not have the opportunity to interact with the Profiles entered into the PCX Application.⁷³ Thus, once the Cycle is completed, resulting orders sent to the PCX for execution at such limit order's price or better would bypass the limit order, even though such limit order had priority under the PCX's current rules. The Commission acknowledges that there is a possibility of this scenario occurring. Because of the virtually instantaneous nature of the Cycles, however, such a scenario is likely to occur very infrequently.⁷⁴

⁷² For example, if a specialist received a customer limit order to buy 1,000 shares at 20 prior to the commencement of a Cycle, and the best priced order generated by the Cycle was assigned a price of 19½, involving 900 shares, with the next best priced order at 19¾, involving 1,000 shares, the specialist would be obligated to fill 900 shares of the customer limit order at 19½, and fill the balance at 19¾.

⁷³ NYSE Second Comment Letter, *supra*, note 45, at 2.

⁷⁴ Contrary to NYSE's understanding, PCX specialists would not be required to guarantee customer limit orders booked after the commencement of a Cycle at prices obtained as a result of such Cycle.

Fourth, the Commission notes the Exchange's representations that the operation of the PCX Application would be consistent with the Exchange's and its members' obligations under the ITS Plan. Specifically, the Exchange represents that the PCX Application would be operated in a manner consistent with the Exchange's intermarket price protection obligations under the ITS Plan. The PCX Application would incorporate existing market interest from each of the ITS participant markets in the form of CQS Profiles. All orders priced inferior to the quotations of another ITS participant market would be executed on the Exchange only upon submission of appropriate ITS commitments seeking to reach such better-priced interest. For orders representing matched coordinates from CQS Profiles and other Profiles, the Exchange would submit an ITS commitment reflecting each such order for execution on other market centers to which the OptiMark System is not directly linked. Every ITS commitment would be sent under the give-up of the member User or the Designated Broker, by way of the traditional Exchange linkage to the ITS, in the sequence in which orders are generated from the Cycle.

PCX has represented that it proposes to send ITS commitments resulting from the PCX Application in the same way as other ITS commitments are currently sent by the Exchange. The Commission notes that PCX has represented that the Application will be implemented in a manner fully consistent with the ITS Plan, and PCX is engaged in discussions with other ITS participants regarding the requirements of the ITS Plan.

The Commission believes that PCX has adequately represented that its proposed disclaimer of liability (proposed PCX Rule 15.8) covering the operation of the PCX Application does not operate to change or modify in any way PCX's obligations for clearance and settlement of trades matched through the Application and submitted for execution on another market center pursuant to the ITS Plan.

Fifth, the Commission also believes that the PCX will meet its obligation with respect to the reporting of transactions resulting from the Application. The Exchange has represented that transactions resulting from orders routed to the PCX floor from the Application would be reported to the CTS in the sequence in which such orders are generated from a Cycle. The Exchange has represented that it would report these trades in a manner similar to the way it currently reports other trades in PCX Securities to the CTS.

Transaction reports resulting from a Cycle of the Application, moreover, would not be distinguishable on the CTS from the trade report of any other order executed on the PCX floor. Although such transaction reports may occur in rapid sequence, with numerous reports being generated in a short period of time, the individual transaction reports would still be reported and displayed in order of the execution of the transactions.

Sixth, although non-members would have access to the Application, such access would only be through an Exchange member broker-dealer. Before submitting Profiles to the PCX Application, non-members would be required to designate a member firm that would authorize their access to the PCX Application and accept responsibility for these non-member transactions. The Exchange states that it expects the Designated Brokers, or the clearing brokers of the Designated Brokers, to impose credit limits on non-member Users of the PCX Application.⁷⁵ Other exchanges have allowed non-members to access their facilities through member broker-dealers under similar conditions. For example, the Chicago Stock Exchange's Chicago Match System provided for direct non-member access through personal computers and modems, using a member broker-dealer give-up. The non-member access permitted by the Commission with respect to the Chicago Match System is substantially similar to the non-member User access proposed by PCX.⁷⁶

⁷⁵ Further, Exchange members would be required to maintain information and records concerning non-members access for which they are responsible. The Exchange has represented to the Commission that it would require its members to make such non-member User information available to the Exchange upon request, so that the PCX can fulfill its duties regarding surveillance.

⁷⁶ See Securities Exchange Act Release No. 35030, concerning the Chicago Match System, *supra*, note 61. As with the PCX Application, the CHX required non-member users of the Chicago Match System to enter into several agreements to ensure that a CHX member had responsibility and control over the non-member's activities. These responsibilities, included, among other things, controlling and clearing the orders entered by non-members, assuming legal responsibility of the non-member orders entered, and ensuring appropriate credit limits. See *id.* The Commission's approval order for the Chicago Match System also noted that the then anticipated non-member use of the Chicago Match System was analogous to non-member access to the NYSE's Designated Order Turnaround System (now referred to as "SuperDOT"). The SuperDOT System is an electronic order-routing system that enables NYSE members and their customers to transmit market and limit orders in all NYSE-listed securities directly to the specialist post where the securities are traded, or to the member firm's booth. Non-member customers, however, must obtain the electronic means to access SuperDOT through a

Seventh, PCX is adopting reasonable requirements for the clearance and settlement of transactions resulting from the Application. In particular, the Commission believes it is appropriate for PCX to require that: (i) All orders generated by the Application that are executed on PCX or another market center through ITS be reported and entered into the comparison system on a locked-in basis; (ii) orders generated by the Application on behalf of a member User and the resulting transactions be cleared and settled using that member User's mnemonic (or its clearing broker's mnemonic, as applicable); and (iii) orders generated by the Application on behalf of a non-member User and the resulting transaction be cleared and settled using the appropriate Designated Broker's mnemonic.

Finally, the Commission believes that PCX has established that short sales effected through the Application, pursuant to the requested exemption and in accordance with the restrictions contained in proposed Rule 15.3(b), would not be susceptible to the practices that Rule 10a-1 is designed to prevent. PCX has amended its proposal to provide for substantial compliance with Rule 10a-1.⁷⁷ PCX represents that the first match of a Cycle, if it involves a short sale, would be in compliance with Rule 10a-1. Subsequent matches would use the price of the immediately preceding match in the Cycle, rather than the last trade in the consolidated transaction reporting system as a reference. The Division of Market Regulation, by delegated authority, intends to grant PCX an exemption from Rule 10a-1 to permit matches within a Cycle (those subsequent to the initial match) to use the immediately prior match as a reference for determining compliance with Rule 10a-1. The Commission, therefore, believes that PCX has adequately addressed concerns arising under the short sale rule.

The Commission finds that good cause exists to grant approval to Amendment Nos. 1, 2, and 3 to the proposed rule change on an accelerated basis. Collectively, these amendments

broker-dealer member. Like the Chicago Match System, the NYSE's SuperDOT system requires NYSE members to monitor customers' electronic orders and to provide the NYSE with an acknowledgement indicating their responsibility for orders. See *id.*

⁷⁷ The NYSE asserted that new Rule 15.4 proposed by PCX improperly stated that "the Exchange's short sale rule (Rule 5.18) shall not be applicable to any resulting transaction in the Exchange." See Letter from James E. Buck, NYSE, *supra*, note 4, at 4. The Commission notes that the PCX has removed this statement from proposed new Rule 15.4.

reflect PCX's proposed handling of short sales affected through the Application and clarify PCX specialist obligations relating to price protection for orders generated by the Application. The short sale amendment narrows the scope of the proposed short sale exemption attendant to OptiMark transactions. Moreover, as stated above, the Commission has determined that PCX's proposed short sale restrictions substantially mirror the requirements of Rule 10a-1 and are designed in a manner that will not permit the types of short sale practices Rule 10a-1 was designed to prohibit. Accordingly, the Division intends to issue PCX an exemption from Rule 10a-1. In addition, the Commission believes that the amendments pertaining to specialist price protection obligations resulting from orders generated by the Application merely clarify and provide explanatory examples of how the PCX rules relating to the Application will ensure price protection of limit orders. The Commission therefore finds good cause to accelerate approval of Amendment Nos. 1, 2, and 3.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 1, 2, and 3. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by October 15, 1997.

VI. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act.⁷⁸

⁷⁸ 15 U.S.C. §§ 78f and 78s(b)(2).

It therefore is ordered, pursuant to Section 19(b)(2) of the Act,⁷⁹ that the proposed rule change (SR-PCX-97-18) is hereby approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸⁰

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97-25319 Filed 9-23-97; 8:45 am]

BILLING CODE 8010-01-M

SMALL BUSINESS ADMINISTRATION

Mid-Atlantic States Regional Fairness Board; Public Hearing

The Mid-Atlantic States Regional Fairness Board will hold a public meeting on Thursday, September 25, 1997, at the CitiCorp Center, 135 E. 35th Street, 14th Floor, Room J, New York, NY, to inform the small business community of the existence of a regulatory enforcement oversight process and of SBA's desire to collect information regarding businesses' experience with regulatory enforcement actions, and to discuss such matters as may be presented by members, staff of the U.S. Small Business Administration, or others present.

For further information, please contact Gary P. Peele at (312) 353-0880.

Dated: September 12, 1997.

Debra Silimeo,

Deputy Associate Administrator, Office of Communications and Public Liaison.

[FR Doc. 97-25274 Filed 9-23-97; 8:45 am]

BILLING CODE 8025-01-P-M

DEPARTMENT OF TRANSPORTATION

Surface Transportation Board

[STB Ex Parte No. 290 (Sub No. 5) (97-4)]

Quarterly Rail Cost Adjustment Factor

AGENCY: Surface Transportation Board, DOT.

ACTION: Approval of rail cost adjustment factor.

SUMMARY: The Board has approved a fourth quarter 1997 rail cost adjustment factor (RCAF) and cost index filed by the Association of American Railroads. The fourth quarter 1997 RCAF (Unadjusted) is 1.104. The fourth quarter 1997 RCAF (Adjusted) is 0.738. The fourth quarter 1997 RCAF-5 is 0.718.

EFFECTIVE DATE: October 1, 1997.

⁷⁹ 15 U.S.C. § 73s(b)(2).

⁸⁰ CFR 200.30-3(a)(12).